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# FRBSF WEEKLY LETTER

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## California Banking Problems

1992 was a record earnings year for the U.S. banking industry, but one that many California bankers would rather forget. Over 93 percent of the nation's 11,382 commercial banks reported a profit for the year. Industry performance was bolstered by improvement in the economy, record net interest margins, and steadily improving asset quality. In contrast, only 69 percent of California's 450 banks were able to record a profit for 1992, as earnings were depressed by ongoing asset quality problems.

This *Weekly Letter* examines the divergence in 1992 bank performance between California and the nation. California banks have been hurt by the weak California economy and by their relatively heavy exposure to real estate lending. In 1992 small banks operating in Southern California's metropolitan areas experienced the most serious deterioration in performance, a finding that is consistent with economic conditions in Southern California relative to the rest of the state.

### Record year for the industry

Nationally, wider net interest margins, improved asset quality, and asset growth came together to generate a record \$32 billion in earnings in 1992, up from only \$18.3 billion in 1991. As a result of these strong earnings fundamentals, return on assets (ROA), which measures the net income per dollar of assets, climbed to an industry record of 0.94 percent for the year, a dramatic increase from the 0.54 percent ROA recorded in 1991.

Bank earnings were boosted over \$8 billion by the large increase—24 basis points on average—in the differential between interest rates that banks earned on their loans and investments and the costs of funding those assets. Lower interest rates in 1992, and a shift to a funding mix with more equity funding and a larger share of lower cost retail deposits, resulted in a much larger

decline in interest expense than in interest income.

The problem loan ratio for total loans (defined as loans 30 days or more past due plus loans no longer accruing interest divided by total loans) at U.S. banks has now fallen for seven consecutive quarters. From year-end 1991 to year-end 1992, this ratio fell from 6.12 percent to 5.07 percent; and despite the sluggish economic recovery, problem ratios declined for real estate, business, and consumer loans. The improved outlook for credit quality allowed banks to reduce their 1992 expenses for provisions for building loan loss reserves by nearly \$8 billion from 1991 expense levels.

### California's problems

California has accounted for a large share of the nation's job losses since the onset of the recession and it has been slow to show signs of recovery. With the slump in the California economy, earnings of banks in the state continue to lag those reporting nationally. Overall ROA for banks in the state was 0.58 percent last year (this excludes first quarter losses by Security Pacific, before its acquisition by Bank of America). Although this ROA is about triple the earning ratio posted in 1991, it is well short of the national figure. Also, nearly 31 percent of the state's banks, including two of the state's ten largest banks, reported losses in 1992, compared to only 25 percent in 1991.

There were three primary reasons that California bank earnings did not keep pace with the recovery in bank earnings nationally. First, while net interest margins improved at California banks, they did not increase nearly as much as they did nationally. Second, California banks have yet to experience the same degree of asset quality improvement as have U.S. banks. In California, the problem loan ratio appeared to peak in the

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## WESTERN BANKING

*Western Banking* is a quarterly review of banking developments in the Twelfth Federal Reserve District. It is published in the *Weekly Letter* on the fourth Friday of January, April, July, and October.

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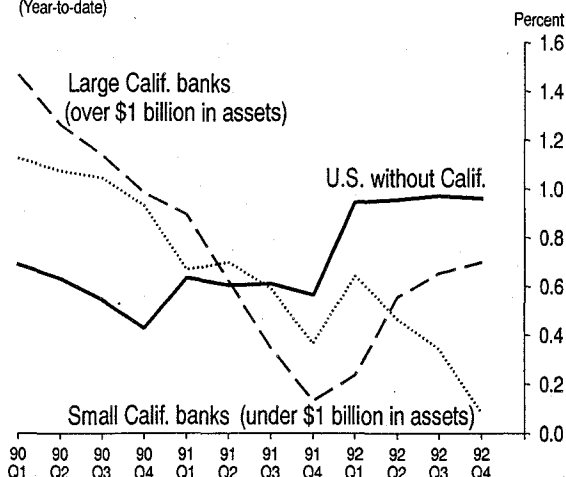
first quarter of 1992, a year later than nationally, and from year-end 1991 to year-end 1992 fell from 6.96 to only 6.71 percent. Moreover, despite the improvement in total loans, the ratios for problem construction loans and single family mortgages continued to climb through year-end 1992. Finally, California banks' assets contracted by 6.6 percent in 1992 as the result of a 10.5 percent decline in total loans, while banks nationally generated earnings by expanding their assets by 2.1 percent.

## Losses at small banks

Figures for the U.S. show that earnings were strong for banks of all sizes in 1992. For example, banks with assets below \$1 billion had an excellent year, as ROA climbed above 1.00 percent. In California, however, quite a different pattern emerged, as 90 percent of 1992 bank earnings were concentrated in a few of the state's largest banks. Indeed, as a group, California's larger banks (over \$1 billion in assets) posted a sharp increase in earnings, with ROA up to a favorable 0.71 percent for 1992, about twice its 1991 ratio (see Figure).

**Figure 1: Return on Assets**

(Year-to-date)



But banks in California with under \$1 billion in assets reported an ROA of only 0.09 percent for 1992. The state's smallest banks, with assets under \$100 million, suffered a net loss for the year. Unlike their larger statewide branch bank competitors, many of these banks are dependent on smaller local banking markets that are more likely to be susceptible to adverse local economic conditions.

Earnings problems arising from relatively high ratios of problem loans and net chargeoffs of problem assets took a significant toll on California banks in 1992. Small banks in particular have been hard-hit because they find it harder to diversify their lending activity outside of their local market area and because of their heavy concentration in real estate lending (63 percent of loans at these banks) at a time when some local real estate markets have been hurt by the state's weakened economy.

One way to examine the effects of local business conditions on banks is to look at the performance of community banks (assets of under \$300 million) across the state. This analysis clearly highlights the problems of community banks in the six metropolitan counties in the hard-hit Southern California region. The 215 banks in that area, with combined assets of \$19 billion, 6 percent of the state's total, suffered a huge loss in the fourth quarter of 1992. For the year they posted a net loss of \$82 million, for an ROA of -0.42 percent. Also, problem real estate loan ratios for community banks in Southern California remained well above the ratios for their peers located elsewhere in the state.

Other parts of the state, including the San Francisco Bay Area, have experienced job losses, but less so than Southern California. The 71 community banks in the Bay Area of Northern California reported virtually no earnings for the entire second half of 1992, but were able to post a 0.32 percent ROA for the entire year. Outside of the two major metropolitan centers, the state's other 89 community banks continued to report relatively low ratios of problem loans and strong earnings, a pattern that is generally consistent with economic conditions in these areas.

## Light at the end of the tunnel?

Earnings problems arising from high ratios of problem loans and net chargeoffs of problem assets took a significant toll on California banks in 1992, especially small banks in Southern California. California banks' problem loan ratios still remain relatively high compared to the national figures; however, these banks bolstered their financial position by adding \$4 billion in equity capital in 1992, and their loan loss reserve ratio also remains well above the U.S. average. But, perhaps the best news for California banks was the overall improvement in asset quality in the fourth quarter and the tentative signs of improvement in the 1993 employment data. Taken together, these signs may mean that some relief is in store for the California banking industry.

**Gary C. Zimmerman**  
Economist

**REGIONAL BANK DATA**  
**DECEMBER 31, 1992**  
 (NOT SEASONALLY ADJUSTED, PRELIMINARY DATA)

		DISTRICT	ALASKA	ARIZ.	CALIF.	HAWAII	IDAHO	NEVADA	OREGON	UTAH	WASH.
<b>ASSETS AND LIABILITIES -- \$ MILLION (ALL COMMERCIAL BANKS)</b>											
ASSETS	TOTAL	498,219	4,739	36,265	329,325	22,434	10,061	14,397	25,825	14,343	40,831
	FOREIGN (RESIDUAL)	24,591	0	0	22,300	2,184	0	0	0	69	37
	DOMESTIC	473,629	4,739	36,265	307,025	20,250	10,061	14,397	25,825	14,274	40,793
LOANS	TOTAL	334,926	2,162	20,098	228,907	13,891	6,739	7,868	17,394	8,402	29,476
	FOREIGN (RESIDUAL)	27,719	5	0	26,241	1,437	0	0	0	0	37
	DOMESTIC	307,207	2,147	20,098	202,666	12,453	6,739	7,868	17,394	8,402	29,439
	REAL ESTATE	162,649	946	7,105	119,183	7,217	2,110	2,573	7,218	3,361	12,945
	COMMERCIAL	62,755	723	2,654	40,194	3,266	1,480	820	4,481	1,567	7,588
	CONSUMER	55,706	345	6,117	28,922	1,128	1,962	4,318	3,503	2,782	6,662
	AGRICULTURE	5,766	4	348	3,029	50	763	14	413	156	990
	INTERNATIONAL	121	0	8	113	0	0	0	0	0	0
SECURITIES	TOTAL	69,629	1,990	8,220	37,401	4,433	1,801	3,559	4,611	3,269	4,326
	U.S.T.S.	22,871	881	2,695	11,292	2,183	410	1,588	1,398	714	1,512
	SECONDARY MARKET	35,527	577	4,699	20,897	1,713	807	1,553	2,318	1,702	1,459
	OTHER SEC.	11,432	532	826	5,412	537	584	418	897	872	1,354
LIABILITIES	TOTAL	457,282	4,135	32,947	303,321	20,831	9,327	12,863	23,521	13,092	37,244
	DOMESTIC	432,691	4,135	32,947	281,022	18,647	9,327	12,863	23,521	13,023	37,207
DEPOSITS	TOTAL	403,051	3,804	29,768	270,838	15,342	7,965	10,103	20,572	10,896	34,161
	FOREIGN (RESIDUAL)	24,206	0	0	22,183	1,915	0	0	0	69	37
	DOMESTIC	378,846	3,803	29,768	248,655	13,427	7,965	10,103	20,572	10,827	34,124
	DEMAND	95,431	1,075	6,148	68,359	2,548	1,580	2,615	4,224	2,336	8,547
	TIME AND SAVINGS	283,414	2,529	23,620	182,296	10,879	6,385	7,489	16,348	8,291	25,577
	NOW	42,965	335	3,537	25,703	1,637	1,046	1,325	3,276	1,516	4,559
	MMDA	94,148	555	7,345	66,191	1,959	1,511	2,473	4,298	1,797	8,020
	SAVINGS	44,024	688	3,381	26,721	3,058	924	1,737	2,195	1,564	3,756
	SMALL TIME	69,686	460	7,868	40,230	2,073	2,310	1,069	5,634	2,756	7,285
	LARGE TIME	32,232	453	1,489	23,232	2,149	593	842	941	854	1,879
OTHER BORROWINGS		32,249	496	2,590	14,712	4,946	1,229	1,750	2,380	2,135	2,011
EQUITY CAPITAL		40,937	604	3,317	26,004	1,803	735	1,534	2,304	1,251	3,586
LOAN LOSS RESERVE		10,138	40	543	7,555	230	107	362	452	195	655
LOAN COMMITMENTS		197,491	632	29,605	121,916	6,490	2,367	1,789	10,186	6,538	17,969
LOANS SOLD		20,853	29	248	19,685	131	33	90	221	138	279
<b>EARNINGS AND RETURNS -- \$ MILLION, YEAR-TO-DATE (ALL COMMERCIAL BANKS)</b>											
INCOME	TOTAL	45,867	419	2,804	30,406	1,778	877	2,023	2,532	1,410	3,838
	INTEREST	36,035	344	2,204	23,837	1,577	755	1,373	1,923	1,137	2,883
	FEES & CHARGES	2,792	23	205	1,882	45	58	58	181	83	257
EXPENSES	TOTAL	39,298	310	2,623	26,829	1,405	691	1,429	2,008	1,093	2,909
	INTEREST	13,713	111	939	9,104	712	319	276	721	441	1,090
	SALARIES	8,868	93	634	6,053	324	126	183	530	211	714
	LOAN LOSS PROVISION	4,603	16	228	3,583	81	37	253	145	68	193
	OTHER	12,114	89	823	8,090	288	209	717	612	373	912
INCOME BEFORE TAXES		6,581	109	181	3,570	373	186	594	523	317	729
TAXES		2,669	33	85	1,615	136	65	205	185	104	242
NET INCOME		3,891	77	115	1,946	247	123	389	310	213	472
ROA (%)		0.78	1.61	0.33	0.58	1.13	1.24	2.92	1.20	1.51	1.17
ROE (%)		9.50	12.67	3.46	7.48	15.43	16.88	25.38	13.45	17.05	13.16
NET INTEREST MARGIN (%)		4.47	4.91	3.61	4.41	3.96	4.42	8.25	4.65	4.94	4.45
<b>ASSET QUALITY -- PERCENT OF LOANS (LARGE COMMERCIAL BANKS)</b>											
LOAN LOSS RESERVE (ALL BANKS)		3.03	1.84	2.70	3.30	1.65	1.59	4.60	2.60	2.32	2.22
NET CHARGE-OFFS, TOTAL		1.33	0.79	1.35	1.52	0.40	0.33	3.38	0.85	0.55	0.54
	REAL ESTATE	1.05	0.90	1.12	1.29	0.11	0.08	0.51	0.49	0.37	0.13
	COMMERCIAL	1.21	0.89	2.75	1.30	0.85	0.49	0.83	1.15	0.52	0.57
	CONSUMER	3.08	0.55	1.90	3.96	0.99	0.53	5.47	1.45	1.67	1.18
	AGRICULTURE	0.26	0.00	1.57	0.07	1.13	0.36	0.26	0.18	0.63	0.22
	PAST DUE & NON-ACCRUAL, TOTAL	5.86	2.34	4.72	6.71	3.12	2.09	7.23	3.15	2.14	4.73
REAL ESTATE		7.55	2.00	6.67	8.54	3.27	2.87	8.10	3.71	2.86	5.96
	CONSTRUCTION	21.27	2.09	18.43	23.74	8.78	9.85	16.30	10.22	3.49	19.05
	COMMERCIAL	8.10	1.78	11.82	9.47	0.88	2.97	8.15	4.58	3.55	3.79
	FARM	7.29	0.00	25.47	7.31	10.65	3.63	0.00	5.52	10.06	3.55
	1-4 FAMILY REV	1.17	0.53	0.93	1.19	1.25	0.27	0.88	N/A	0.80	0.86
	1-4 FAMILY OTHER	3.08	1.47	2.69	3.41	3.99	1.58	3.53	N/A	1.47	1.42
	MULTI-FAMILY	6.38	2.07	9.08	7.27	2.91	0.33	9.36	1.13	0.49	3.83
	COMMERCIAL	5.72	2.99	9.90	6.08	3.66	1.84	14.17	3.11	2.58	5.08
	CONSUMER	3.49	2.37	3.18	4.08	2.54	1.67	5.85	1.90	1.33	1.91
	AGRICULTURE	4.21	0.00	6.24	3.72	15.78	2.54	5.85	5.19	2.94	5.54
NUMBER OF BANKS		749	8	38	452	17	20	18	48	54	94
NUMBER OF EMPLOYEES		246,669	2,830	19,887	160,467	8,488	4,723	6,076	16,190	7,152	21,256

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## MARKET SHARE STATISTICS

DEPOSITORY INSTITUTIONS REQUIRED TO HOLD RESERVES WITH THE FEDERAL RESERVE ON A WEEKLY BASIS

PERCENT OF COMBINED MARKET TOTAL FOR FEBRUARY 1993, BY REGION

DISTRICT	ALASKA			ARIZONA			CALIF			HAWAII			IDAHO			NEVADA			OREGON			UTAH			WASH		
DEPOSIT TYPE	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU
TOTAL DEPOSITS	54	39	6	70	4	28	92	1	7	48	46	6	95	29	5	91	5	4	73	23	3	81	10	9	77	8	15
DEMAND	90	5	5	99	0	1	96	0	4	89	6	5	89	3	8	95	0	5	97	3	0	94	1	5	90	3	6
NOW	84	28	8	59	6	35	88	0	10	58	38	7	87	31	3	93	3	4	78	16	6	84	8	8	82	3	15
SAVINGS & MMDAS	80	31	9	55	4	41	90	0	9	56	37	7	80	34	7	82	4	4	80	15	5	77	10	13	70	6	24
SMALL TIME	32	65	3	75	9	18	95	1	4	23	74	3	52	46	2	88	10	1	43	54	3	77	17	6	77	15	7
LARGE TIME	44	46	10	95	2	3	93	0	6	39	51	10	73	22	6	89	6	5	62	38	0	75	12	13	70	10	19

CB = COMMERCIAL BANKS; SL = SAVINGS & LOANS AND SAVING BANKS; CU = CREDIT UNIONS; MAY NOT SUM TO 100% DUE TO ROUNDING

## INTEREST RATES ON DEPOSITS AND LOANS AS OF FEBRUARY 1993 (%)

TYPE OF ACCOUNT OR LOAN	DATE	US	DISTRICT	ARIZ	CALIF	HAWAII	IDAHO	OREGON	UTAH	WASH
SAVINGS ACCOUNTS AND MMDAS	DEC92	2.88	3.05	2.72	2.77	3.36	3.51	2.88	3.23	3.25
	JAN93	2.85	3.01	2.68	2.73	3.23	3.47	2.86	3.2	3.25
	FEB93	2.8	2.96	2.67	2.7	3.09	3.38	2.79	3.21	3.16
92 TO 182 DAYS CERTIFICATES	DEC92	3.16	3.15	2.88	2.9	3.05	3.24	3.08	3.28	3.49
	JAN93	3.13	3.08	2.87	2.86	2.67	3.22	3.08	3.27	3.47
	FEB93	3.08	3.01	2.83	2.88	2.5	3.19	3.06	3.23	3.38
2-1/2 YEARS AND OVER CERTIFICATES	DEC92	4.77	4.55	4.11	3.98	4.61	5.13	5.05	4.68	4.62
	JAN93	4.72	4.52	4.09	4.04	4.28	5.13	5.05	4.68	4.62
	FEB93	4.59	4.41	4.06	4.01	4.03	5.2	5.05	4.56	4.61
COMMERCIAL, SHORT TERM*	AVE. RATE	4.92	5.96	6.79	5.71	6.85	8	6.25	4.87	5.93
	AVE. MAT. (DAYS)	58	70	N/A	84	101	N/A	305	57	N/A
COMMERCIAL, LONG-TERM*	AVE. RATE	6.39	8.69	N/A	8.99	N/A	N/A	9.25	8.81	N/A
	AVE. MAT. (MONTHS)	44	29	N/A	29	N/A	N/A	35	27	N/A
LOANS TO FARMERS*	AVE. RATE	7.62	6.33	6.76	6.07	N/A	7.51	6.81	8.72	7.03
	AVE. MAT. (MONTHS)	14	22	N/A	21	N/A	N/A	N/A	30	N/A
CONSUMER, AUTOMOBILE	AVE. RATE	8.57	8.98	8.9	9.02	N/A	10	8.78	8.9	8.51
CONSUMER, PERSONAL	AVE. RATE	13.57	12.67	15	13.87	N/A	10.5	11.34	11.5	11.68
CONSUMER, CREDIT CARDS	AVE. RATE	17.26	17.76	14.9	18.8	N/A	N/A	19.25	14.9	18.3

SOURCES: SURVEY OF TERMS OF BANK LENDING AND TERMS OF CONSUMER CREDIT; MOST COMMON INTEREST RATES ON SELECTED ACCOUNTS.

\* DATA ARE COMPOUNDED ANNUAL RATES.